Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Review of Differential Pricing in the Private Car and Home Insurance Markets

Interim Report

December 2020

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1. Executive Summary

1.1 Overview

The Central Bank of Ireland (the 'Central Bank') works to ensure that the financial system operates in the best interests of consumers and the wider economy. Consumer protection is central to our work, including in how we supervise the insurance sector. An essential objective of this work is that insurance markets operate in a fair and transparent manner.

We launched our Review of Differential Pricing in the Private Car and Home Insurance Markets (the 'Review') because of the potential risk to consumers arising from this practice. Differential pricing is where customers with a similar risk and cost of service are charged different premiums for reasons other than risk and cost of service.

As highlighted in our Financial Stability Note published in November 2020, the practice of differential pricing is widely used across a range of markets, and can bring benefits for consumers. For example, it can encourage competition and innovation and it can facilitate market access for consumers who might be unable or unwilling to pay a uniform price. However, differential pricing can also bring costs for consumers, particularly if it affects vulnerable groups or those with a lower ability or willingness to search for better offers.

The Review aims to:

- Establish the impact of differential pricing on consumers;
- Assess the extent to which these pricing practices lead to outcomes consistent with the Consumer Protection Code (the 'Code');
- Identify the drivers of consumer behaviours including how consumers engage with the insurance industry; and
- Assess the adequacy of the governance and oversight of differential pricing.

The Review is being conducted in three phases as follows:

- Phase 1: Market Analysis;
- Phase 2: Quantitative Analysis and Consumer Insights; and
- Phase 3: Conclusions and Recommendations.

This interim report provides a progress update on our work, which will continue into 2021. It includes initial observations arising from our market analysis (Phase 1) and from the commencement of our in-depth data analysis and consumer research (Phase 2), where significant further work is ongoing.

1.2 Observations to Date

Following our initial market analysis work, we issued a 'Dear CEO letter' to the insurance sector in September 2020 setting out our initial observations, outlining our next steps and setting out our requirements to insurance providers in relation to governance, culture, conduct and consideration of customer impact.[1]

The market analysis conducted to that point identified weaknesses of varying degrees in insurance providers in scope of the Review, raising concerns that some firms were not adequately considering the effect of their pricing practices on their customers, potentially leading to poor customer outcomes.[2]

This report outlines further observations from our market analysis, including detailed data analysis and consumer-led research, as Phase 2 progresses. These observations, along with those outlined previously in our Dear CEO letter, will inform our remaining work.

Market Analysis

The Review involved the analysis of more than 2,000 documents submitted by 11 firms. We also undertook a series of 33 targeted inspections to obtain a detailed understanding of the pricing practices in place, the governance and oversight within the pricing process and how each of the firms considered the customer as part of their pricing practices. This information was examined alongside our analysis of three years of data gathered from the firms.

To date our market analysis shows:

- The majority of firms apply some form of differential pricing;
- A number of pricing practices were identified that led to customers with a similar risk and cost of service paying different premiums for reasons other than risk and cost of service;
- Dual pricing is evident across the private car and home insurance markets. This is a form of differential pricing where new and renewing customers are charged different premiums for reasons other than risk and cost of service. In general, renewing customers are paying significantly more than the expected cost of the policy, while new business customers are paying marginally less than the expected cost of the policy;

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1 For the purpose of this report, 'insurance provider' includes insurance companies and insurance intermediaries.

2 For the purpose of this report, insurance providers in scope of the Review are referred to as 'firms'.

- Customers less sensitive to price may subsidise those who are more price-sensitive, thus giving the insurance provider a greater chance of securing those customers' business;
- On average, the longer a customer remains with their insurer, the higher the amount they pay in excess of that required to cover the expected cost of the policy; and
- Firms failed to demonstrate consideration of how pricing practices may impact certain groups of consumers differently, and the potential for certain consumer groups to be impacted more than others.

Consumer Research

To ensure a thorough understanding of the impact of differential pricing, we conducted targeted consumer research, through focus groups and in-depth interviews, to inform our work. Engaging directly with consumers and hearing their experiences helps us form a complete view and better understand both consumer behaviours and the broader impact of these practices.

The research to date shows:

- Consumers are aware of the legal requirements associated with insurance. However, as consumers do not see it as a discretionary purchase, it is frequently considered in largely negative terms. This results in both a lack of trust and lack of interest;
- The complexity of insurance means most consumers have a limited knowledge of how the specifics of insurance operates. This can discourage more active involvement and there is a tendency to feel it is better and easier to stay with the current insurance provider rather than switch;
- Consumers tend to involve themselves more in private car insurance than home insurance. With home insurance, there is a much higher level of inertia. Many consumers do not review their home insurance on an annual basis; and
- Across the research, there is a clear preference for staying with an existing insurance provider. In fact, many consumers report that they compare prices with other insurance providers largely because it helps to negotiate a better price with their current provider, rather than switch provider.

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1.3 Next Steps

Phase 2 of the Review is ongoing, as we undertake further intensive data analysis to test the factors that are most important in driving differential pricing.

We will conclude our consumer insights survey of approximately 5,500 insurance consumers.

The survey responses will be combined with data gathered from the firms for the three year period 2017 to 2019 to provide insights into how certain consumer features may relate to price variations found in the data. This will help to identify potential underlying factors that are most significantly related to differential pricing practices and the characteristics of those groups that are being most affected by such practices.

While our research and analysis continues, supervision of insurance providers will continue to ensure the concerns arising from Phase 1 of the Review are addressed. We require insurance providers to address issues relating to governance and oversight of their differential pricing practices, to ensure that they understand the impact of such practices on their customers and that they have a fully embedded Consumer Protection Risk Management Frameworks to drive positive behaviours.

On conclusion of Phase 2, consideration of the likely costs and benefits of any potential solution to risks identified is essential, with appropriate consideration given to market and consumer price effects. Once this work has concluded we will publish a report and/or a consultation on proposals for reform, as appropriate, in 2021.

2. Background

The Review is examining the pricing practices of non-life insurance companies and insurance intermediaries to understand the prevalence and impact of differential pricing - the practice of charging customers who have similar risk and cost of service different premiums for reasons other than risk and cost of service.[3]

2.1 Role of Insurance

Insurance serves a critical role in reducing uncertainty by protecting people and businesses against the risks of future events. Consumers rely on insurance to provide support in the event of loss or serious accident, to plan for retirement, to invest confidently in and run their businesses, and much more besides. A functioning financial services system, that sustainably serves the needs of the wider economy and its consumers, therefore requires fully functioning and trustworthy insurance markets and insurance providers.

The Central Bank defines differential pricing in insurance services as a circumstance or practice whereby customers with a similar risk and cost of service are charged different premiums for reasons other than risk and cost of service.

2.2 What is Differential Pricing?

The Central Bank defines differential pricing in insurance services as a circumstance or practice whereby customers with a similar risk and cost of service are charged different premiums for reasons other than risk and cost of service.

Differential pricing includes a range of techniques that combine information about expected claims experience and customer behaviour - for example, the tendency to renew or shop around.

Differential pricing is not unique to the insurance sector - such techniques are widely used across many industries, such as airlines, hotels, telecoms and on-line retail sites.

"From a policy perspective, price differentiation can be associated with benefits and costs for consumers, which may require a trade-off between different policy goals (OECD, 2018). For example, it can encourage customers to try new products or providers to avail of lower prices, it can promote new business growth and competition as firms attract customers away from existing providers,

Price differentiation can be associated with benefits and costs for consumers.

3 For the purpose of this report, non-life insurance companies are referred to as insurers.

it can facilitate expanded market access for consumers who could not afford to pay a single undifferentiated price, and it can promote innovation among firms (CMA, 2018). On the other hand, differential pricing can have an unclear effect on distributional equity (OECD, 2018)".[4]

Customers may not always be aware of price differentiation or, even if they are, they may not engage in sufficient search and negotiation to avoid it. This can result in adverse effects for consumers, particularly if the tendency to engage in effective search and negotiation is less likely with customers who have characteristics of vulnerability (e.g. age, income or financial capability) or have behavioural biases that create barriers to customer engagement.

2.3 What are we Doing?

The Review is focusing on the private car and home insurance markets as these products are two of the most commonly held insurance products in Ireland. The Review is examining the pricing practices of a number of the largest non-life insurance providers operating in the Irish market.

The Review is being conducted in three phases as follows:

Phase 1 **Market Analysis**

- Establish the extent to which differential pricing is in operation in the Irish private car and home insurance markets and if it does exist, to establish how it is being carried out.

Phase 2 **Quantitative Analysis and Consumer Insights**

- Examine the degree of differential pricing among private car and home insurance policies via analysis of datasets provided by each firm in scope for this review.
- Conduct a consumer insights survey for extrapolation of insights to the wider population.

Phase 3 **Conclusions and Recommendations**

- Informed by the findings in Phases 1 and 2 of the Review.
- The outputs of Phase 3 will be a report or consultation on proposals for reform, as appropriate.

4 Byrne, S. and McCarthy, Y. (2020) 'Differential Pricing: The Economics and International Evidence', 2020(10), pp. 1 [Online]. Available at: Financial Stability Note

2.4 Why are we Undertaking the Review?

The Central Bank serves the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy.

The advances in computing power, data analysis and modelling techniques within the insurance industry increases the risk that pricing practices may deliver unfair outcomes for some customers.

Among other things, the Review is examining the extent to which the practice of differential pricing is consistent with the Code, which states:

"A regulated entity must ensure that in all its dealings with customers and within the context of its authorisation it acts honestly, fairly and professionally in the best interests of its customers and the integrity of the market."

The Central Bank, in common with other National Competent Authorities, is adjusting its supervision of insurance providers to oversee changes in pricing practices from a conduct of business perspective. This is to ensure that insurance providers are fully compliant with their obligations and treat consumers in a fair and transparent way.[5]

[5] It should be noted that, in the context of its mandate, the Central Bank is not permitted to introduce prior notification or approval of proposed increases in premium rates.

3. Market and Pricing Overview

Private car and home insurance can be sold through a variety of channels.

Insurance premiums reflect individual policyholder characteristics as well as other market factors.

3.1 Market Overview

Private car and home insurance products offer consumers financial protection in the event of accident or loss, and play an important role in providing consumers peace of mind in this regard. Private car insurance is a legal requirement, with a minimum cover of third party required in order for an individual to legally drive on public roads. While home insurance is not a legal requirement, it is perceived by homeowners and renters to be an important purchase, and is often required by lending institutions in order to secure a mortgage. Private car and home insurance products fulfil an important role in society, with a significant proportion of the population requiring one or both products during their lifetime.

There are approximately 2.2 million private car insurance policies and 1.3 million home insurance policies in the Irish market.[6] Based on these numbers, we estimate that the Review covers more than 90% of policies insured in these markets.

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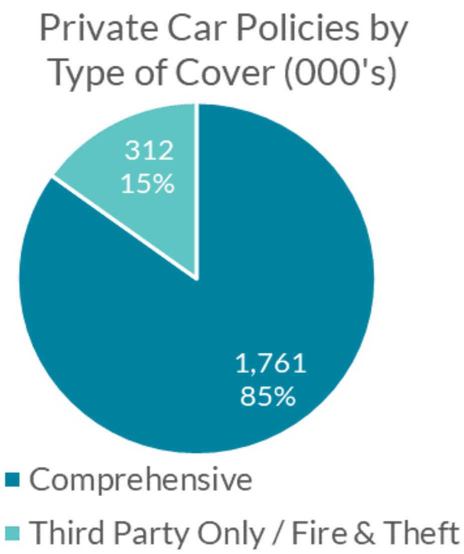
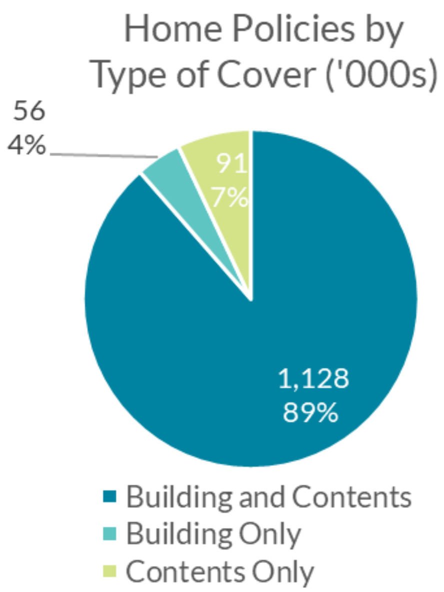
Private car policies are held in the form of fully comprehensive, third party fire and theft, or third party only. From the data submitted by firms, 68% of the private car policies written in 2019 were renewals, and 32% new business, with an average premium of €672 for renewal and €826 for new business.



[6] Data sourced from the 2019 Conduct of Business Returns provided by regulated firms.

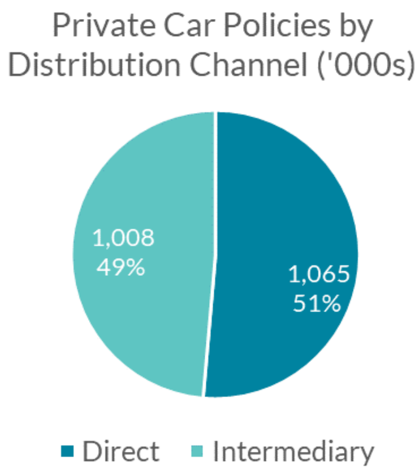
Home Insurance policies are held in the form of buildings and contents, buildings only, or contents only. From the data submitted by firms, 77% of the home insurance policies written in 2019 were renewals, and 23% new business, with an average premium of €409 for renewal and €319 for new business.

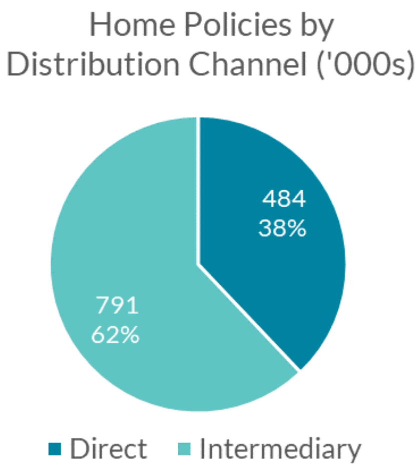


Private car and home insurance policies can be purchased through different types of insurance providers as set out below.

Insurance provider type	Role	Pricing
Insurers	Design, manufacture, underwrite and distribute insurance products.	When selling directly, the insurer sets the price that customers pay.
Insurance Intermediaries	Advise on and distribute insurance products but do not underwrite risk. *Managing General Agents:* ▪ *MGAs are insurance intermediaries but can also manage part or all of an insurer's business under a delegated authority, which may include advising on and distributing insurance products, as well as underwriting risk.*	The insurer sets the premium with the insurance intermediary setting the price that customers pay. *Managing General Agents:* ▪ *The insurer may delegate authority to an MGA to set the premium.*

From the data submitted by the firms, approximately half of private car policies were purchased directly from the insurer and half through an insurance intermediary. For the home insurance market, the majority of policies were purchased through an insurance intermediary.





3.2 How Does Insurance Pricing Work?

An insurance premium is the amount paid to an insurance provider to cover the risk of personal injury or property damage to third parties and the risk of loss of, or damage to, the policyholder's car or home. An insurance premium is calculated by the insurer based on a number of individual factors that are combined to determine a price. Insurance premiums will be determined by considering individual policyholder characteristics as well as other market factors.

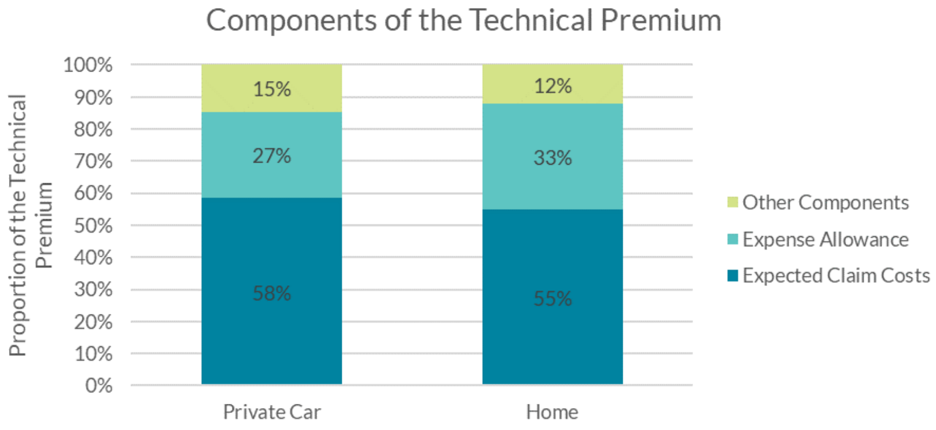
Factors specific to the policyholder may include, for example, the type of car they drive, the age of the car, the number of bedrooms in the home and location of the home. Market factors may include the level of awards for injury claims and the cost of replacement parts for a car. An insurance premium may be higher or lower based on both these policyholder characteristics and market factors.

The Technical Premium is the insurer's view of the cost of providing an insurance policy.

The Technical Premium is the insurer's view of the cost of providing an insurance policy.[7] The Technical Premium for an insurance policy will vary over time, for reasons including a change in the policyholder's details, changes to the insurer's expenses and variation in the cost of claims observed in the market.

[7] The Technical Premium is a starting point of premium calculation for many insurers; however, it is not always possible to reflect the true expected cost of claims in this figure.

Based on the data submitted by firms, the graph below demonstrates the breakdown of Technical Premium for private car and home insurance into expected claims costs, an allowance for expenses, and other components.[8] [9]



The Actual Premium is the amount paid by the policyholder.[10] The Actual Premium paid may include further adjustments to the Technical Premium, which do not relate to the expected cost to the insurer of the policy, such as profit or premium optimisation and discretionary discounts.[11]

The Actual Premium is the amount paid by the policyholder.

Insurers commonly analyse the ratio of Actual Premium to Technical Premium (the 'APTP' ratio) to monitor the sufficiency of their premiums.[12] [13] The APTP ratio provides us with a view of the differences between the cost of providing the policy and the Actual Premium charged.

As part of the Review, we considered the extent to which the APTP ratio varies across factors such as tenure (the length of time a policyholder has remained with a particular insurer), and across various segments such as new business and renewal, based on data provided for the three year period 2017 to 2019 inclusive (unless otherwise stated). Further analysis being conducted will show any variances in the APTP ratio across different groups of consumers. In considering this ratio, it is important to note that there may be differences in the APTP ratio for reasons other than non-risk modelling.

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8 The expense allowance includes costs associated with administering a policy as well as commission payments made by insurers to insurance intermediaries.

9 Other components include items such as manual risk-based adjustments, allowances for levies, reinsurance costs, and costs of policy cover add-ons.

10 Administration fees are included in Actual Premium.

11 There may be other constraints on the Technical Premium leading to differences between the Technical Premium and the Actual Premium. These may include legal constraints, such as the restriction on gender-based pricing in the Actual Premium, and IT systems constraints.

12 In the case of intermediated policies that could be linked to insurers participating in the Review, we use a calculated premium. This is the Actual Premium received by the insurer plus fees and any non-risk adjustments.

13 Some firms were unable to provide data on Technical Premium, and as a result, they were excluded from our analysis of APTP ratios.

4. Market Analysis Observations

This phase of the Review targeted four key areas: Pricing Practices and Methodology; Governance, Controls and Consideration of Customer Impact; Customer Information and Engagement; and Culture and Conduct. This was supported by quantitative data gathered from firms.

The Market Analysis phase of the Review involved the analysis of more than 2,000 documents submitted by the 11 firms in respect of their pricing practices.

Following the analysis of the documentation, the Central Bank conducted a series of 33 targeted inspections, capturing each of the firms, to obtain a detailed understanding of the pricing practices in place, the governance and oversight within the pricing process and how each of the firms considered the customer as part of the pricing practices. This information was overlaid with our analysis of the data gathered from the firms. This data covered the three year period 2017 to 2019, capturing almost 11 million policy records, with each record holding up to 60 different data points.

4.1 How do Differential Pricing Practices Impact on Consumer Outcomes?

As noted in Section 3.2, the difference between the Actual and Technical Premium is an indicator of the amount the policyholder is paying relative to the amount required to cover the expected cost of the policy.

In our analysis, the APTP ratio is used as a metric for measuring the impact of pricing practices on different groups of consumers. The ratio was selected as it offers a relative comparison of Actual and Technical premium, which can be used to consider how premium varies by consumer group or factor.

Insurance providers often rely on less price-sensitive customers to subsidise the premium of more price-sensitive customers, thus giving the insurance provider a greater chance of securing those customers' business. The less price-sensitive customer is likely to pay a higher relative premium, although the absolute amount may be less. For example, while Section 3.1 showed that the average premium for private car customers renewing their policies in 2019 was less than that of new business customers, Section 4.1.2

The APTP ratio is the ratio of Actual Premium to Technical Premium. A ratio greater than 1 indicates the insurer is charging a higher premium than is needed to cover the expected cost of the policy.

will show that they paid a greater amount compared to the expected cost of their policies. In this case, the less price-sensitive renewal customers paid a higher relative premium.

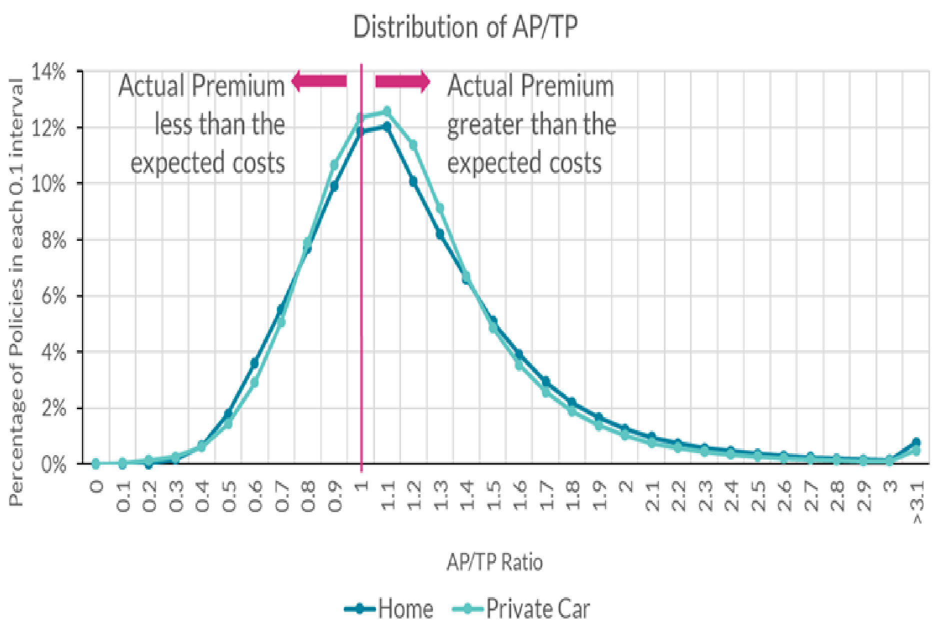
The following sections discuss the observed level of differential pricing across the market and how consumer outcomes are potentially impacted.

Insurance providers may subsidise the premium charged for more price-sensitive groups of consumers with that of less price-sensitive consumer groups.

4.1.1 Differential Pricing in Use across the Market

From the analysis completed, it is evident that insurance providers may subsidise the premium charged for more price-sensitive groups of consumers with that of less price-sensitive consumer groups. At an overall level, the insurance provider may receive a similar total premium across their portfolio; however, some consumers are paying an amount in excess of that required to cover the expected cost of their policy.

From the Review, it is evident that the majority of firms apply some form of differential pricing.[14] The graph below shows the spread of the APTP ratio for private car and home insurance. Where the Actual Premium is the same as the expected cost, the APTP is 1. The average APTP ratio is 1.07 for private car and 1.12 for home. These averages, and the chart below, highlight the differences that customers experience between the cost of providing their policies and the Actual Premium paid. Based on the data provided by firms, there is significant variation in APTP ratios within the market.



14 In relation to some graphs in Section 4, it should be noted that the chart axes have been adjusted to allow for the highlighting of trends observed.

4.1.2 Dual Pricing

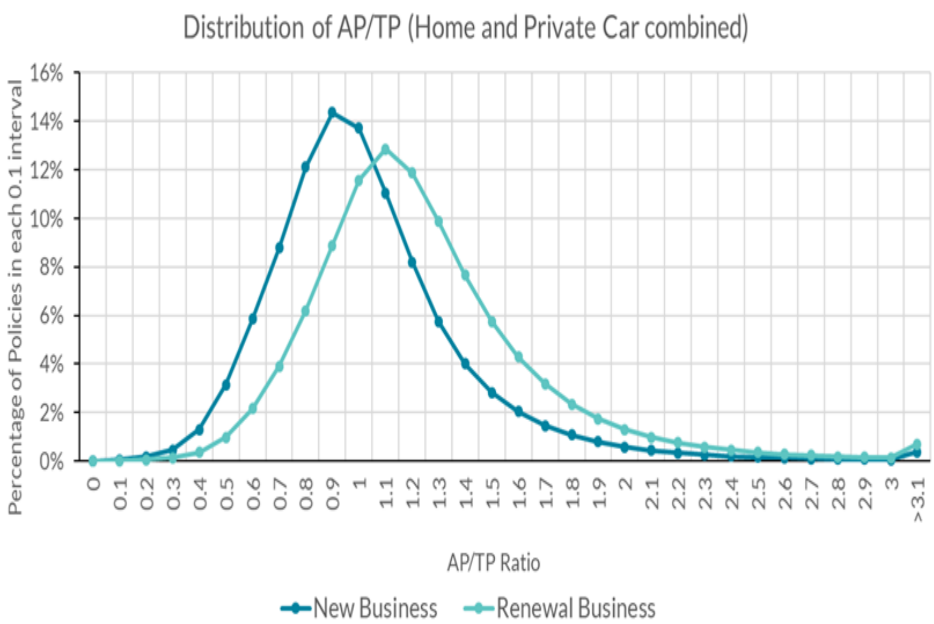
Dual pricing is a form of differential pricing, whereby new and renewing customers are charged different premiums for reasons other than risk and cost of service. It was observed that offering new business discounts is a strategy widely practised across both the private car and home insurance markets. New business customers may be offered a discounted price in order to secure their business, while firms typically offset this introductory discount approach by charging renewing customers a higher premium.

Dual pricing is evident across the private car and home insurance markets.

Combined Market

The graph below shows the spread of the Actual Premium to Technical Premium for new and renewal business (for private car and home insurance combined). It is evident that a larger proportion of renewals (light teal line) have an APTP ratio greater than 1 (indicating that the policyholder is paying a higher premium than is needed to cover the expected cost of the policy) when compared to new business (dark teal line).

72% of renewal business experiences an APTP of greater than or equal to 1, compared to 47% for new business. In general, renewing customers are paying significantly more than the expected cost, while new business customers are paying marginally less than the expected cost.



Case Study 1: Illustrative example

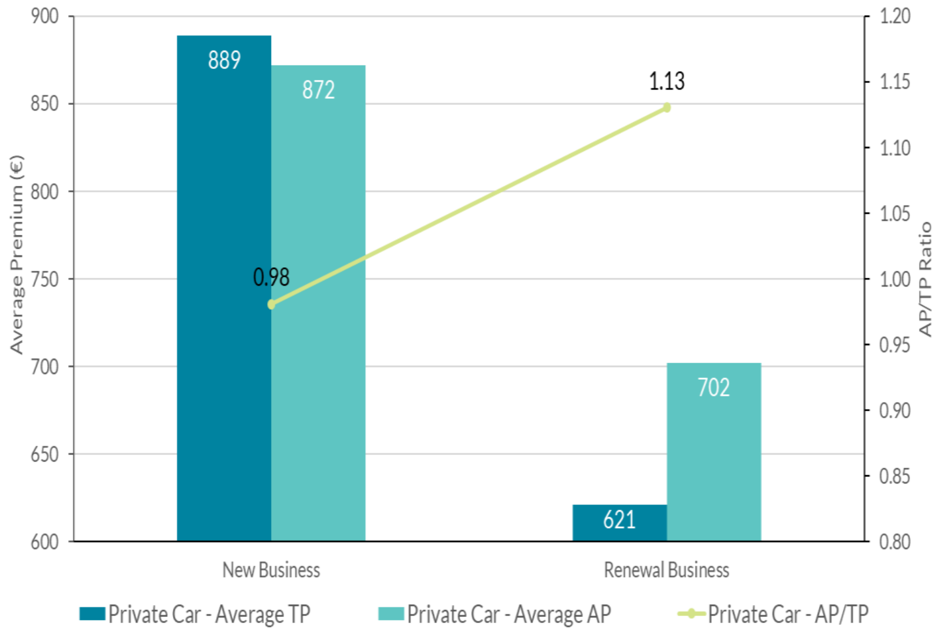
Consider two private car insurance customers: a new business customer and a renewal customer. They have the same Technical Premium of €700, reflecting the fact that the two customers have a similar combined risk and cost of service.

The new business customer has an APTP ratio of 0.98 (average new business APTP ratio), which means their Actual Premium is €686. In comparison, the renewal customer has an APTP ratio of 1.13 (average renewal business APTP ratio), which means their Actual Premium is €791. In this example, a renewal customer with the same Technical Premium is paying €105 more than the new business customer.

Private Car Insurance Market

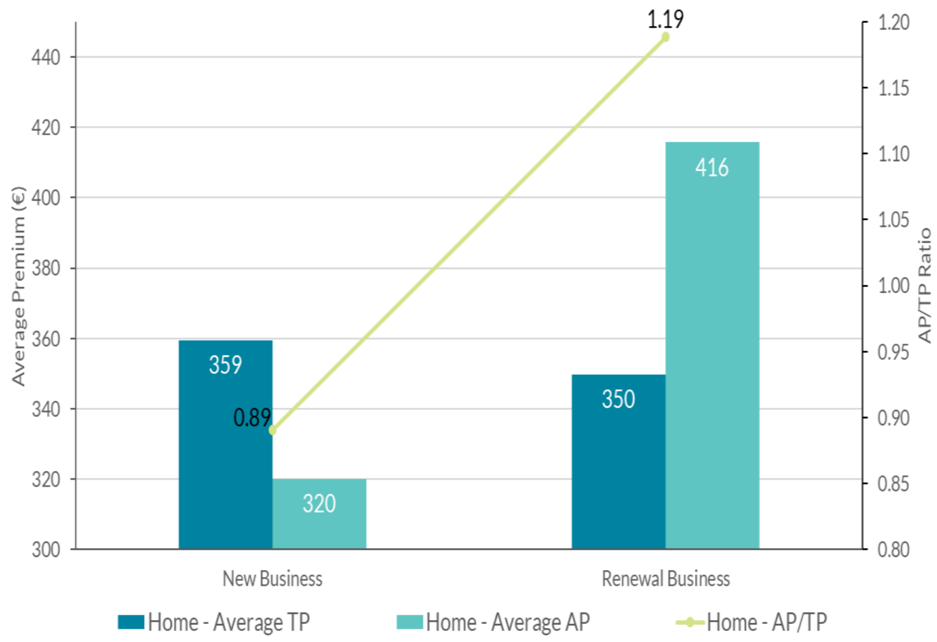
For private car insurance, the average Technical Premium is considerably lower for renewal compared to new business. However, for renewal business, while the average Technical Premium decreases, the average Actual Premium decreases to a lesser extent, resulting in a higher Actual Premium being charged relative to the Technical Premium (or expected cost). In other words, even though the price they pay upon renewal may be reducing, the policyholder is paying a higher premium relative to the expected cost of the policy.

As a result, renewal business experiences a higher APTP ratio compared to new business.



Home Insurance Market

In relation to home insurance, despite the expected cost (Technical Premium) of renewal business being marginally lower than the expected cost of new business, the Actual Premium charged to renewal business is significantly higher than the Actual Premium charged to new business, resulting in a higher APTP ratio for renewals. We observed that the average premium charged in 2019 was 29% higher for renewal business than for new business, despite the expected cost of renewal business being 6% lower than new business. Our consumer research, as set out in Section 5, showed that there is a much higher level of inertia with home insurance than with private car insurance, which may be a factor.



Insurance providers may offer discounted prices to prospective new business customers in order to secure their business. Insurance providers may adopt this approach in order to secure business with a view to retaining this policy over a number of years, and recouping the discount provided at new business over the lifetime of the policy. This results in renewal customers subsidising the premium of new business customers.

The average home insurance premium charged in 2019 was 29% higher for renewal business than for new business, despite the expected cost of renewal business being 6% lower than new business.

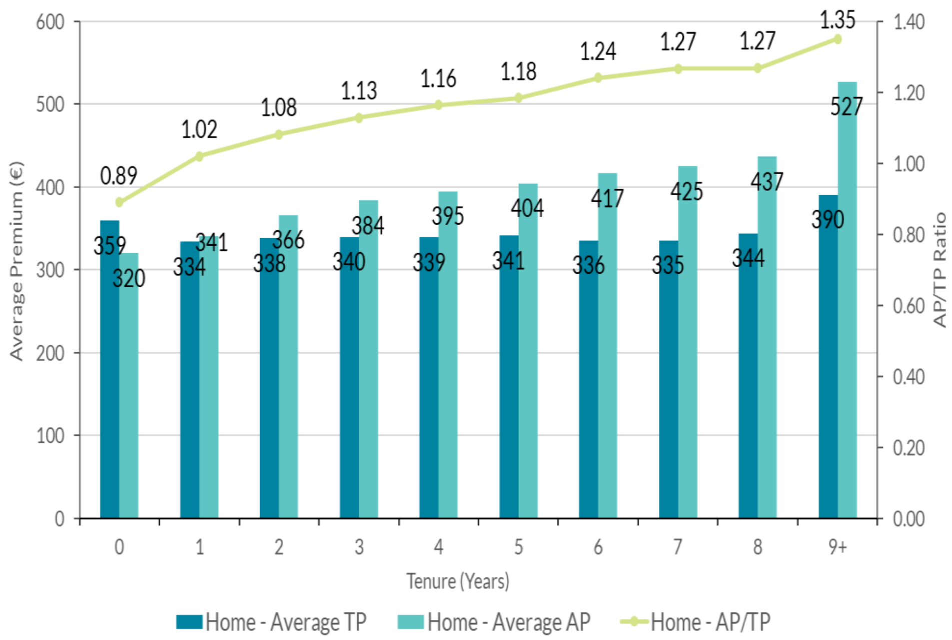
4.1.3 Policyholder Tenure

Tenure is the length of time a policyholder has remained with a particular insurer.

On average, the longer a customer remains with their insurer, the higher the amount they pay in excess of that required to cover the expected cost of the policy.

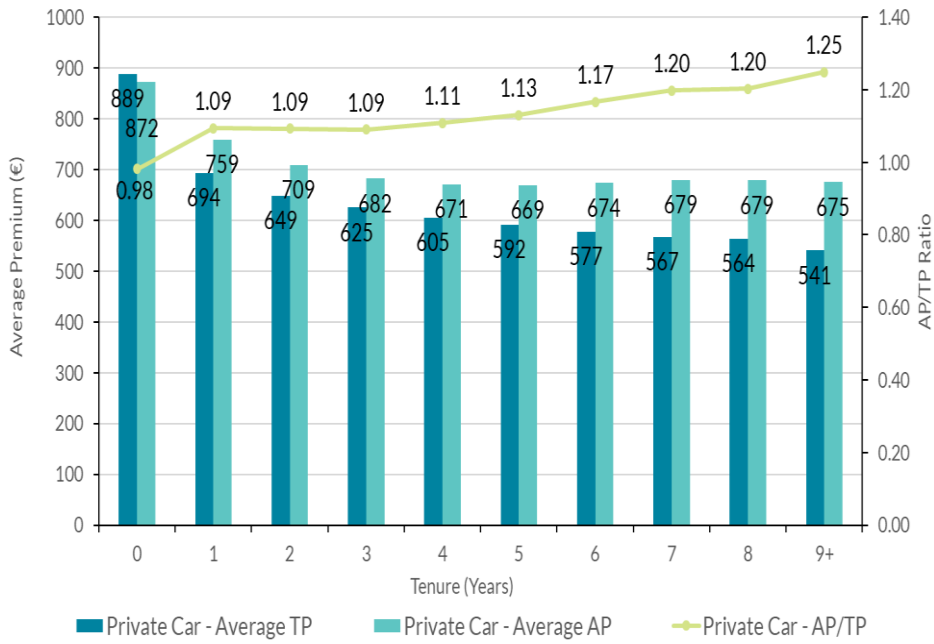
Our consumer research showed that there is a clear preference among consumers for staying with an existing insurance provider. In fact, the purpose of comparing prices with other insurance providers is largely to help negotiate a better price with their current provider (rather than risk switching).

The graph below shows the trend of premium and APTP over policy tenure for the home insurance market. On average, new business customers pay a premium that is 11% below the expected cost. As tenure increases, the APTP ratio increases, meaning that, on average, the longer a customer remains with an insurer, the higher the amount they will pay in excess of that required to cover the expected cost of the policy.



For the private car insurance graph below, Technical Premium decreases over tenure, whereas the average Actual Premium remains relatively flat from year 3 onwards. As a result, policyholders with longer tenures experience a higher APTP ratio.

Our consumer research showed that consumers typically take no action when the premium remains similar to the previous year. Consumers feel that their insurance providers are treating them fairly with regard to price, and this typically reinforces inertia.



An increase in premium charged, year-on-year, for renewal business for reasons other than risk and cost of service may be referred to as price walking. This may be viewed as a loyalty penalty, where customers are charged a higher amount as their tenure increases.

Analysis of the data suggests that there is a correlation between age and tenure, where older customers tend to have higher loyalty years. Therefore, loyalty penalties appear to disproportionately affect older customers. Further analysis is in progress to identify the underlying characteristics of those customer groups that are most affected by differential pricing.

In relation to both the private car and home insurance markets, as a customer's tenure increases, the extent to which they subsidise new business customers' premiums increases.

Case Study 2: Illustrative example

Consider two home insurance customers: a new business customer and a year one renewal customer. They have the same Technical Premium of €350, meaning that the two customers have a similar combined risk and cost of service. With an APTP ratio of 0.89 (average new business APTP ratio), the new business customer has an Actual Premium of €312. The renewal customer in year one has an APTP ratio of 1.02 (average year 1 APTP ratio), resulting in an Actual Premium of €357.

Now consider a third customer, who has been with the same insurer for nine years, and also has a Technical Premium of €350. This customer has an APTP ratio of 1.35 (average 9+ years APTP ratio), resulting in an Actual Premium of €473. In this example, the year one and year nine renewal customers are paying €45 and €161 more than the equivalent new business customer, respectively.

The renewal customers are subsidising the new business customer. As the renewing customers' tenures increase, the extent to which they subsidise the new business customer increases.

4.2 Pricing Practices and Methodologies

As seen above, the Review has found that the majority of firms apply some form of differential pricing. Differential pricing can arise simply, for example, through customer negotiation at point of sale. However, more sophisticated differential pricing methods may involve price modelling by firms.

4.2.1 Models in Use

The more sophisticated differential pricing methods involve the use of Retention and Conversion Rate models as set out below.[15]

Differential pricing approaches	How they work
Retention model	Estimates the likelihood of a policy renewing with the insurance provider based on a given combination of factors –may reflect customer buying behaviour and/or an insurance provider's relative competitiveness in a particular market segment.
Conversion rate model	Estimates the likelihood of a new business quote converting into new business – may reflect customer buying behaviour and/or an insurance provider's relative competitiveness in a particular market segment.
Price testing factor model	Applies small rate adjustments to randomly selected risks and analyses conversion/renewal rates – insurance providers may use results to better understand how much they *can* charge customers.
Caps and collars	Limits year-on-year increase (cap) or decrease (collar) experienced by customer on renewal – assists with retaining customers.
Point of sale discounts	Allows new business and renewal customers to negotiate discounts at the point of sale.

15 As noted by the European Insurance and Occupational Pensions Authority (EIOPA), in applying these models, *"insurance firms may identify that they are able to charge these consumers more than they would charge similar customers in terms of risk and cost to serve, and increase prices accordingly at point of renewal"*. EIOPA (2019) 'Big Data Analytics in Motor and Health: A Thematic Review' pp. 39 [Online]. Available at: https://register.eiopa.europa.eu/Publications/EIOPA_BigDataAnalytics_ThematicReview_April2019.pdf

The use of retention and conversion models appears to be more prevalent in the private car insurance market and in the direct-to-customer sales channel. These models analyse customer characteristics, comparing characteristics of those who have renewed/converted against those who have lapsed/not converted. These characteristics could include, for example, year-on-year premium change, age of vehicle, occupation, etc. Insurers are then able to estimate who is more or less likely to renew/convert their policy.

Insurers can use this information to adjust premium. In the case of renewals, customers who are expected to be more likely to remain with the insurer would get a premium load and those who are expected to be more likely to leave the insurer would get a premium discount as a result of these models.

Insurance intermediaries may have the ability to optimise retention or profit using differential pricing models. For example, they may identify policies that are less likely to convert or renew and offer these customers higher discounts; for policies that are more likely to convert or renew, the insurance intermediary may offer smaller discounts, if any.

4.2.2 Understanding Customer Elasticity

From the Review, it was evident that many firms attempt to understand customer elasticity. This is where firms identify individual characteristics that assess a customer's sensitivity to price. Firms try to capture buying behaviours and use customer information to tailor their pricing.

This information can then be used to increase or decrease premiums for certain customers.

Our consumer research showed that only a large increase in premium tends to prompt consumers to shop around. Critically, most consumers return to their own insurance provider with any cheaper quote received elsewhere, seeking to stay with their current insurance provider where possible.

4.2.3 Pricing Practices - Conclusion

From the Review, we have identified a number of pricing practices that lead to customers with a similar risk and cost of service paying different premiums for reasons other than risk and cost of service. We have observed that, on average, renewing customers pay a higher amount relative to the expected cost of their policy when compared to new business customers. We have also observed that, on average, the longer a customer remains with their insurance provider the higher the amount they pay in excess of that required to cover the expected cost of the policy.

4.3 Governance, Controls and Consideration of Customer Impact

4.3.1 Governance

While the majority of firms have developed pricing policies, they have not sufficiently considered the impact of their pricing practices on customers.

While firms have various pricing and consumer-focused committees/sub-committees in place to support the board of directors in respect of pricing decisions and related activities, there was insufficient evidence that firms have the level of ownership and oversight expected when they apply differential pricing practices.[16] There were varying degrees of awareness of pricing practices at board level and, in many cases, it was not evident that boards had appropriately considered or discussed the impact of their firms' differential pricing practices on their customers.

4.3.2 Controls

Monitoring conducted by firms in respect of pricing tends to focus on performance metrics such as conversion and retention rates, profitability and discretionary spend. Firms failed to demonstrate consideration of how pricing practices may impact certain groups of consumers differently, and the potential for certain consumer groups to be impacted more than others.

While it is evident that firms monitor metrics relating to the treatment of customers including: complaints; customer feedback; and quality control checks of customer engagements, there is minimal evidence to suggest they are monitoring the impact of pricing activities on consumers.

Failure to have appropriate frameworks and controls in place prior to the implementation of differential pricing practices results in insurance providers being unable to effectively monitor the impact of their pricing activities and unable to evaluate how their pricing decisions affect customer outcomes.

4.3.3 Customer Impact

The Code requires insurance providers to act fairly in the best interest of their customers and the integrity of the market. While a small number of firms have begun developing and incorporating fairness principles into their pricing practices and customer monitoring, the majority have not undertaken any specific monitoring of fairness in respect of customer outcomes from their own differential pricing practices.

The majority of firms have not undertaken any specific monitoring of fairness in respect of customer outcomes from their own differential pricing practices.

16 References to boards includes local management functions in firms not prudentially supervised by the Central Bank.

Some firms have demonstrated their consideration of the factors underlying the pricing models and the impact on certain groups of consumers. We have observed measures taken to test the impact of differential pricing models by location of the insured person in order to mitigate against any unintended discriminatory impact of these pricing models. Some firms have cited the “Equal Status Acts 2000 - 2018” as a reason for removing ‘age’ from their differential pricing models, for example.

A minority of firms have commenced work to further develop their pricing policies in relation to their use of differential pricing practices, and a number of them have also indicated that they intend to conduct additional work/reviews in this area.

A small number of firms were able to demonstrate how they considered the customer in their differential pricing practices. In these cases, the firms had taken actions to limit the extent of non-risk modelling on customers. This included limiting the difference between renewal and new business prices, and introducing upper limits on the APTP ratio.

4.3.4 Governance, Controls and Consideration of Customer Impact - Conclusion

While it was evident that a small number of firms had commenced work to further develop their pricing policies, standards across the sector were not satisfactory. Accordingly, following our initial market analysis work (Phase 1) of the Review, we issued a number of requirements to insurance providers given the governance and oversight weaknesses identified. We set out our observations in our Dear CEO letter and we require insurance providers to:

- Ensure greater governance and oversight of their differential pricing practices;
- Understand the impact of such practices on their customers; and
- Ensure a fully embedded Consumer Protection Risk Management Framework to drive positive behaviours.

4.4 Customer Information and Engagement

On review of firm documentation provided to customers for both new and renewal private car and home insurance policies, it was noted that the information provided varied in detail by firm and policy type.

Firms typically include details such as: gross premium; discounts; optional extras; levies; charges; and total premium payable, in addition to the prior year's premium and alternative product options available. However, firms do not provide a breakdown of how the gross premium is calculated. While it should be noted that insurers are not required to provide this information, its absence makes it difficult for customers to assess the underlying reasons for any changes in premium.

In the event that a customer contacts their insurance provider following receipt of their renewal invitation, the majority of firms are willing to negotiate on the renewal price via the offering of discounts. However, failure by the customer to proactively engage with their insurance provider may result in them paying more than customers who actively engage.

Where customers obtain an online new business quotation that is cheaper than the offered renewal premium, the majority of firms will match the online quotation at the customer's request. However, some firms will request the customer to proceed online to 'renew' as a new customer in order to avail of the lower premium.

In the event that a customer enquires why their premium has increased, where their situation remains unchanged, firms' responses are typically based on generic scripts, which may result in customers not having a clear understanding as to why their premium has increased. In a minority of firms, a listing of possible reasons explaining why a premium might increase was available on the firm's website.

In the majority of firms, the information provided to customers, and the requirement for customers to proactively engage with firms following receipt of their renewal invitation in order to negotiate a better price, was not adequately considered in the context of customer outcomes.

In order for a customer to be able to make an informed decision in respect of their private car or home insurance policy, documentation and information provided to them must be clear and transparent.

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4.5 Culture and Conduct

While the majority of firms have developed pricing policies, firms were unable to provide sufficient evidence of a consumer-focused culture in respect of pricing decisions and practices.

A minority of firms have made improvements in setting out consumer consideration in their pricing documentation and implementing mechanisms to promote fair treatment of customers. For example, some firms have processes in place to avoid particular groups of consumers being treated unfairly in their pricing practices.

Most firms have Head of Consumer roles and consumer forums/committees in place. It is positive that firms have developed these initiatives and are conscious of the importance of the consumer voice; however, there is limited evidence of them being actively involved in pricing discussions or decisions.

It is noted that in the majority of firms, staff remuneration is linked to good customer outcomes and quality standards, which helps to reinforce behaviour that is aligned to and promotes a positive consumer-focused culture. However, failure to ensure that customers are at the centre of pricing decisions raises questions regarding how customers' interests are considered as part of the pricing process and creates significant concerns in respect of a firm's culture.

While the majority of firms have developed pricing policies, firms were unable to provide sufficient evidence of a consumer-focused culture in respect of pricing decisions and practices.

5. How Consumers View Insurance

Consumers expressed a clear preference for staying with an existing insurance provider, assuming no substantial increase in premium was experienced.

Consumer responses to price increases depended on their individual circumstances or experiences with their insurance provider at the time of renewal.

The Consumer Insights phase of the Review is a data-gathering and analysis exercise to determine the scale and prevalence of differential pricing in the private car and home insurance markets.

While a large scale quantitative survey of approximately 5,500 consumers is ongoing, qualitative research, including focus groups and in-depth interviews, was conducted as part of this data-gathering approach allowing a deeper exploration of consumer attitudes to, and their engagement with, the insurance markets. This quantitative research forms the basis of the insights below.

Consumer Quote:

"It's more convenient to stay where you are. You're kind of hoping they'll meet you half way."

5.1 Consumer Views Towards Private Car and Home Insurance

Consumers tend to see private car and home insurance as an 'obligation' or 'mandatory' in order to drive a car or get a mortgage, respectively. Consumers are aware of the legal requirements associated with insurance. As consumers do not see it as a discretionary purchase, it is frequently considered in largely negative terms.

Initial consumer associations with insurance include *complexity* (details are hard to understand, lots of jargon); and *expense* (limited sense of value for money; intangible benefit).

Our research shows that the complexity of insurance means that most consumers have a limited knowledge of how the specifics of insurance operate.

As many consumers view insurance as difficult and boring, this can discourage more active involvement. While many consumers are suspicious of insurance providers, there is a tendency to feel it is better and easier to stay with their current insurance provider rather than switch.

Consumers tend to see private car and home insurance as an 'obligation' or 'mandatory'.

These negative consumer associations result in both a lack of trust and a lack of interest for many consumers.

There is also a feeling that to make any change (in insurance provider) requires a great deal of effort and form filling.

These perceptions prompt low engagement with the insurance category across the various types of insurance consumers in our research. Its perceived complexity means consumers will not always invest the same time in searching for price-effective insurance as they would with other categories of spending.

5.2 Car Insurance Tends to Dominate Consumer Thinking Towards Insurance

Private car insurance is considered more involving and tends to be given more attention than home insurance. Our sample of consumers felt that private car insurance is a more active and volatile market, where there is a greater need to compare prices. Consumers who took part in this research noted a low sense of trust with private car insurance providers.[17]

With home insurance, there is a much higher level of inertia; indeed, many of our respondents did not review their home insurance on an annual basis. There is a sense that the premium does not fluctuate as significantly and also a feeling that there are fewer product options and a less volatile market. Underlying this, there is a sense that one should not jeopardise or alter one's home insurance cover whereas the private car insurance category is structured more around negotiation.

With home insurance, there is a much higher level of inertia [than with private car insurance].

[17] For the purpose of this report, consumers who participated in the consumer research will be referred to as respondents.

5.3 Personal Interaction is a Common Element for Many Consumers

Personal interaction, typically by telephone, proved to be the default preference or the final step in the process for many consumers. From our research, it is clear that personal interaction is a critical feature for consumers because it delivers:

- **Reassurance** that details are correct and nothing is overlooked.
- **A shift of responsibility** so that the consumer does not feel they are wholly responsible for making the decision.
- **A quicker and easier method** for handling what could be a long drawn out and often complex process.
- **An opportunity to negotiate** (or haggle) thereby achieving a lower premium.

Consumer Quote:

"I like to speak to somebody as well, rather than doing it all online. I like to get my facts first from somebody."

For some consumers who use insurance intermediaries, their relationship with their insurance intermediary dominates their insurance experience to the extent that they may find it difficult to recall the brand name of their current insurer (but can remember the name of their insurance intermediary).

In some cases, the insurance intermediary is also a face-to-face point of contact (town, local office etc.) which provides a greater sense of comfort and of someone acting in an expert, intermediary capacity.

Our research found that consumers using insurance intermediaries typically accept advice and administration charges with limited questioning. Consumers see the insurance intermediary as a way to 'sensibly delegate' their choice of insurer and cover. By doing so, consumers believe it saves them time each year.

Consumer quote:

"I probably rang four different companies and went back and forth. I even got my own crowd down by €30 because I had some deal, but I felt the devil I know is better than the one I don't."

5.4 How Premium Changes Influence Consumer Decisions

Changes in premium influence the action or inaction of consumers to shop around as outlined in the table below:

Size of premium change	Consumer response to premium change
Decrease in premium	In the majority of instances, a decrease in premium prompts no action from the consumer. It typically results in a more positive attitude towards their insurance provider.
Same premium as last year	Consumers typically take no action. Consumers feel that their insurance providers are treating them fairly with regards to price and this typically reinforces inertia.
Moderate increase in premium	Limited action (if any). Our research demonstrated a large degree of comfort with small increases to their premium pricing. Consumers frequently seek to negotiate the price down. If unsuccessful there is readiness to accept a general price rise as normal. There also tends to be less likelihood of switching if consumers can reference previous small incremental changes.
Large increase in premium	A large increase prompts some action although for many consumers this means minimal effort. For example, reviewing a comparison site, checking two or three other insurance provider websites or alternatively, phoning them directly. Critically, most consumers return to their own insurance provider with a cheaper quote they have received elsewhere, seeking to stay with their current insurance provider, as this is viewed as easier, and there is less chance that mistakes will be made. In addition, where there was a significant premium paid in the past, there tends to be more comfort with a larger increase.

Consumer Quote:

"You haven't claimed but others are claiming, left right and centre, that's why our insurance is going up."

Across the research, there was a clear preference for staying with an existing insurance provider. In fact, the purpose of comparing prices with other insurance providers is largely to help negotiate a better price with their current provider, rather than switch.

5.5 Price Rise Narratives

When focus group respondents were presented with the hypothetical scenario that '*your insurance premium has risen*', they offered various beliefs and reasons for this. This consumer understanding or reasoning can be referred to as a 'narrative'. Narratives are not always attributed to a specific source but feel intuitively correct to the consumer.

A 'narrative' can impact on how people modulate their reaction to any price increase. It validates inaction and 'stretches' the threshold for an increase in premium they are prepared to accept. Our research found notable consistency in the feedback from consumers.

Some common price related narratives include:

'All boats rise'
There is a sense that over time the cost of living goes up and that as prices increase for consumer goods, so does the cost of insurance.

Fraudulent claims
There is a sense there is a much higher level of false and fraudulent claims in Ireland than in other countries.

Global catastrophes
Consumers suspect that the whole insurance industry is influenced by global catastrophes such as tsunamis or floods.

Grand conspiracy theory
There is no great difference between major insurance providers and ultimately there is nothing that an average consumer can do to leverage change.

Location-specific
Typically, this relates to either geography (the risk of flooding), or crime rates. Consumers suspect that the location (and its safety) influences the cost of insurance.

5.6 New Customer Discounting is Associated with other Categories

Consumers do not believe insurance providers provide new customer discounts as frequently or readily as other sectors.

The notion of a new insurance customer discount was presented to respondents using the following explanation:

"Some (but not all) insurance firms have a strategy of charging very low prices for new customers, but then increasing prices gradually over time, so that loyal customers can pay substantially more than those who switch more frequently."

Most respondents understand new customer discounting as relevant in other consumer categories (specifically utilities, mobile phone contracts, TV packages, broadband providers, etc.). However, within the private car and home insurance categories, the idea of a new customer discount approach is considered as completely novel and somewhat unlikely.

Typically, consumers have learned that their insurance premium may be influenced by a 'no claims discount' and so, in this sense, they do not connect the same thinking to insurance that they might apply to other consumer categories – "*the less I use/need the provider, the better I will be treated by the insurance provider"* best describes consumer thinking in relation to their insurance provider.

6. Next Steps

Insurance providers are obliged to act with honesty and fairness, and to act in their customers' best interests. This includes having pricing practices that are fair, transparent and disclose material information to customers in a way that is informative.

The practice of differential pricing is widely used across a range of markets, and can bring benefits for consumers. The analysis completed to date, however, has raised concerns that firms are not adequately considering the impact of differential pricing model usage on their customers. It has demonstrated that there are significant differences between what different groups of customers pay relative to the expected cost of their policies with those customers with the longest tenure paying the most. Our analysis has also raised concerns that those consumers who do not switch insurance provider on a regular basis or proactively negotiate a discount at renewal are often worse off than those who do.

It will be necessary to undertake the further extensive analysis outlined in Phase 2 in order to give a full market perspective and ensure that final conclusions and recommendations are evidence-based. Consideration of the likely costs and benefits of any potential solution to risks identified is also essential, with any potential market and consumer price effects given appropriate regard. Once this work has concluded we will publish a report or consultation on proposals for reform, as appropriate, in 2021. The Review remains a priority for the Central Bank.

As our analysis continues and as set out in our Dear CEO letter, our supervision of insurance providers will also continue to ensure they implement the requirements relating to governance and oversight of their differential pricing practices, that they understand the impact of such practices on their customers and that they have a fully embedded Consumer Protection Risk Management Framework to drive positive behaviours.

Appendix 1 – Glossary of Key Terms

Actual Premium – This is the premium paid by the policyholder. The Actual Premium paid may include further adjustments to the Technical Premium that do not relate to the expected cost to the insurer of the policy.

Actual Premium to Technical Premium ('APTP') – This is the Actual Premium divided by the Technical Premium, where Technical Premium is a measure of the premium needed to cover the expected cost of the policy. This ratio is commonly monitored by insurers to check the sufficiency of their premiums. A ratio above 1 suggests that an insurer is charging a higher premium than the amount needed to cover the expected cost of the policy. A ratio of less than 1 suggests the insurer is charging less premium than the amount needed to cover the expected cost of the policy.

Conversion Rate Model – This model estimates the likelihood of a new business quote converting into a new business written policy based on a given premium and customer characteristics which may reflect customer buying behaviour and/or an insurance provider's relative competitiveness in a particular market segment.

Differential Pricing – The Central Bank has defined differential pricing in insurance services as a circumstance or practice whereby customers with a similar risk and cost of service are charged different premiums for reasons other than risk and cost of service. This includes the use of any modelling technique or the application of a non-risk adjustment during the pricing process which leads to customers with a similar risk and cost of service being charged differing premiums.

Discretionary Discount – This is an adjustment made to premiums as part of the negotiation with an individual customer at point of sale.

Dual Pricing – This is a form of differential pricing. This is where new and renewing customers with a similar risk and cost of service are charged different premiums for reasons other than risk and cost of service. When new customers pay relatively lower prices, renewing customers are said to incur a 'loyalty penalty'.

Focus Groups – These are in-depth interviews undertaken with a group of respondents. In addition to the increased number of respondents, they differ from individual depth interviews in that they involve interaction between the participants.

In-depth Interviews – An interview that is conducted in-person or by telephone/online in which the subject matter of the interview is explored in detail using an unstructured and flexible approach.

Non-Risk Adjustment – This is an adjustment which may be made to some or all policies and is not based on risk or cost of service; this means that it is available to any customer and not based on the insurance provider's expectation that the customer in question will have a lower expected cost of claims. Examples of non-risk adjustments include a new business discount, discretionary discount, or a cap on renewal premium.

Optimisation – Optimisation refers to the practice of adjusting the premiums paid by different groups of consumers to achieve certain business objectives. Given an understanding of the behaviours and economic characteristics of consumers in the market, and an awareness of the behaviours of their competitors, insurance providers can aim to adjust premiums paid by different groups of consumers in ways unrelated to their risk or cost of service to maximise overall profit.

Policyholder – This is the person who holds the insurance policy with the insurance provider.

Price Elasticity – This is a customer's sensitivity to price. A customer who is inelastic will not be sensitive to price changes; a customer who is elastic will be sensitive to changes in price. Typically, the former group will subsidise the latter group in a market in which differential pricing models are applied.

Price Walking – This is the practice where insurance providers initially offer a lower premium to customers which is then increased in subsequent years when the customer renews.

Qualitative Research – An unstructured research approach with smaller groups of carefully selected individuals used to produce non-quantifiable insights into behaviour, motivations and attitudes.

Quantitative Research – A structured research approach involving a sample of the population to produce quantifiable insights into behaviour, motivations and attitudes.

Reinsurance – This is a type of insurance purchased by insurers to protect themselves from the risk of losses. It is purchased from another insurer, known as a reinsurer.

Retention Model – This model estimates the likelihood of a policy remaining with the insurance provider based on a given combination of factors; these might include change in premium from last year and certain customer characteristics which might reflect buying behaviour and/or depth of market competition.

Technical Premium – This represents the amount needed to cover the expected costs of an individual policy i.e. it includes the sum of the expected claims costs, and an allowance for the following: expenses, commission, reinsurance, and investment income.[18]

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[18] For the purpose of this report, we have defined the Technical Premium as described for ease of understanding. Technical Premium can include an allowance for profit margin, but we have not included it in our definition of the Technical Premium. Insurers may have different definitions of Technical Premium.

Appendix 2 – Research Methodology

Qualitative Data Collection Approach

This project incorporates a series of 12 group discussions and 12 individual one-to-one in-depth interviews. Given the timing of the project and the target respondents, both online interviewing and some socially distant face-to-face interviews were used.

In-depth interviews were deemed the most appropriate approach to provide a more intimate and sensitive means of probing vulnerability, thus the weighting is slightly different to the group discussion specification.

All focus groups and in-depth interviews were conducted by Behaviour & Attitudes Ltd. who were commissioned by the Central Bank to conduct this research.

Fieldwork dates for the research was 27 July – 5 August 2020.

Qualitative Recruitment Considerations – Who we talked to

The research sought to ensure a broad representation of private car and home insurance consumers in Ireland. The qualitative approaches incorporated a number of important criteria relating to both consumer confidence in insurance and potential consumer vulnerability.

Focus groups and in-depth interviews were conducted with a broad representation of other recruitment criteria such as:

- Age (18-75+);
- Gender;
- Location (including rural and urban); and
- Socio-economic status.

All respondents were recruited to be car insurance, home insurance or car and home insurance decision makers in their household. Home insurance consumers included those renting their home.

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